Weighing the Alternatives to Private Foundations

Vehicles that escape the excise tax rules on private foundations may involve different sorts of problems.

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Donors with substantial assets to contribute to charity have two basic options. They can make current contributions to established charities or create a fund from which to make contributions, either directly or in the future. Those choosing to act through a fund have several possible vehicles for doing so—private foundations, supporting organizations, community foundations, and commercially administered donor-advised funds.

Most of these entities have been available for years, but changes in the legal landscape have shifted the trade-offs that have to be analyzed in choosing between them. Advisors therefore need to assist donors in carefully considering which alternative best matches their needs and desires.

PRIVATE FOUNDATIONS

Private foundations are the most flexible means for ensuring that the assets donors commit to charitable purposes will continue to serve those purposes for the long term. A private foundation is a charitable endowment, organized as either a corporation or trust, described in Section 501(c)(3)—organized and operated exclusively for charitable, educational, or other purposes described in that section. The assets of the foundation are invested, and the resulting income (and sometimes the corpus) is then used to promote the foundation's exempt purposes. The trustees or board of directors of the foundation are initially selected by the donor, after which the posts are usually filled according to procedures spelled out in the governing documents.

The donor may provide as few or as many restrictions as desired in the foundation's governing documents, limited only by state law and the requirements of Section 501(c)(3). For example, the founder of a family foundation can include a provision requiring that at least 60% of the directors or trustees be his or her direct lineal descendants. Donors can thus craft a private foundation in a way that will best be able to pursue the donors' philanthropic vision and have the greatest flexibility possible to adjust its mission and activities as the world changes.

Foundations with sufficient financial resources have the option of hiring and training a professional staff to further pursue the donor's vision. This staff can solicit and review grant applications, work with potential grantees, or help design activities that the foundation will engage in directly. It can also do research and prepare reports for the trustees or the board of directors of the foundation, and provide training for new trustees or directors.

As discussed in greater detail below, the price for this flexibility is the restrictions placed on the operations of private foundations by the Code—primarily Chapter 42—that do not apply to Section 501(c)(3) organizations qualifying as public charities. These restrictions prohibit most financial transactions with officers, directors, and substantial contributors; limit the types of charitable activities foundations can fund; and impose various restrictions on foundation investments. The deductibility of contributions to foundations is

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also subject to lower limits than contributions to public charities.

Foundations that conduct most of their charitable activities directly, instead of through grants, may qualify as "operating foundations" under Section 4942(j)(3). The Code affords this class of foundations more favorable treatment than non-operating foundations in several respects.[1]

SUPPORTING ORGANIZATIONS

Supporting organizations, defined under Section 509(a)(3), are a commonly used public charity alternative to private foundations. A supporting organization is organized and operated to support one or more public charities or publicly supported Section 501(c)(4), (c)(5), or (c)(6) organizations. There are three types of supporting organizations.

1. *Operated, supervised, or controlled by.* Under this alternative, the supported organization (or organizations) controls the supporting organization, generally by appointing or electing a majority of its directors.[2] This type of supporting organization is most likely to be used when a number of organizations decide to join forces to create a shared fundraising entity.
2. *Supervised or controlled in connection with.* This type of supporting organization has a common board of directors with the supported organization(s).[3] This structure is most commonly used when a public charity wants, for organizational reasons, to set up a separate fundraising organization.
3. *Operated in connection with.* In contrast to the Type 1 and Type 2 supporting organizations, the Type 3 alternative allows the donor to select the members of the organization's board, and a majority of the directors may be persons entirely independent of the supported organization. Rather than demonstrating control by the supported organization, the Type 3 supporting organization must show that it is responsive to and an integral part of the supported organization.[4]

The responsiveness demanded of a Type 3 organization can be demonstrated in one of two ways. There can be a small amount of board or officer overlap (a single person is sufficient) and a close working relationship between the boards of the supporting and the supported organization, giving the supported organization "a significant voice" in the supporting organization's activities. Alternatively, the supporting organization can be established as a charitable trust under state law for the benefit of the supported organization, with the supported organization having the right to enforce the trust.[5] To meet the integral part test, the supporting organization must (1) pay most of its net income to the supported organization, (2) allow its assets to be used by the supported organization, *or* (3) perform activities that the supported organization would otherwise perform.[6]

The specific organization (or organizations) to be supported must be explicitly named in the governing documents of a Type 3 supporting organization unless there has been an historic and continuing relationship between the supporting and the supported organizations through which they have developed a substantial identity of interests.[7] By contrast, for Type 1 and 2 supporting organizations, only the general class of organizations to be supported need be identified (e.g., "institutions of higher education located in the District of Columbia").[8]

Disqualified persons, including substantial contributors, may not control any type of supporting organization. This generally means that disqualified persons cannot make up (or have the ability to appoint or elect) 50% or more of the supporting organization's board. The regulations, though, state that all facts and circumstances will be considered in determining whether control exists.[9]

Supporting organizations are free from the restrictions that encumber private foundations, but that freedom comes at a price. First, the supporting organization is tied to a specific group or class of organizations and its activities are limited to supporting those organizations. Second, the

[1] See Sections 4940(d) (exempting some operating foundations from the investment income tax), 4942(g)(3) (exempting operating foundations from certain restrictions when grants are received from private foundations), and 4942(j)(3) (requiring a lower minimum payment rate for operating foundations). Contributions to operating foundations are also subject to more favorable deductibility limits that apply to contributions to public charities. See Sections 170(b)(1)(A)(vii), (E)(i).

[2] Reg. 1.509(a)-4(g).

[3] Reg. 1.509(a)-4(h).

[4] Reg. 1.509(a)-4(i). See Shoemaker and Brockner, "Public Charity Status on the Razor's Edge," *Continuing Professional Education, Exempt Organizations—Technical Instruction Program for FY 1997* (1996). For another interesting perspective on Type 3 supporting organizations, see "Gimme Shelter: The SO Trend: How to Succeed in Charity Without Really Giving," Wall St. J., 5/29/98, page A1.

[5] Reg. 1.509(a)-4(i)(2).

[6] Reg. 1.509(a)-4(i)(3).

[7] Reg. 1.509(a)-4(d)(2)(iv), (4).

[8] Regs. 1.509(a)-4(d)(2), (3).

[9] Reg. 1.509(a)-4(j)(1).

supported organization has substantial control or influence over the supporting organization. Therefore, the ability of the original donors to ensure that their charitable vision is implemented is significantly weakened.

COMMUNITY FOUNDATION DONOR-ADVISED FUNDS

Another public charity alternative to establishing a private foundation is a donor-advised fund in a community foundation. Community foundations are local grantmaking charitable organizations. They are established to hold funds contributed from a variety of sources and to use those funds to make charitable grants for the benefit of the local community. Even though the community trust rules in Regs. 1.170A-9(e)(10)-(14) may not be technically applicable to community foundations organized as corporations, the IRS has indicated that it will look to those rules when determining whether a community foundation qualifies as a public charity.[10]

Community foundations are classified as public charities, so they and their donors receive all of the benefits of that status. According to one survey, there were over 400 community foundations with assets of almost $20 billion and annual grants totaling almost $1.2 billion as of 1997.[11]

Community foundations generally offer donors the option of creating donor-advised funds. With such a fund, the donor and possibly members of his or her family (the exact terms are usually spelled out in a written agreement) has the opportunity to *recommend,* but not direct, how charitable contributions are to be distributed from the fund. Although final authority over how the funds are used rests with the foundation's board, community foundations generally are highly responsive to donor recommendations. The author is aware, however, of at least one dispute between the board of a community foundation and one of the donors to a donor-advised fund that has resulted in litigation.[12]

Donor-advised funds located in community foundations provide the advantages of public charity status without limiting the range of charitable organizations a donor may support, although most community foundations limit their activities to their geographic region. Such funds do, however, limit the form in which donors can pursue their charitable activities, generally permitting only grants to public charities. Thus, they cannot be used for direct charitable expenditures, program-related investments, or grants for charitable activities of non-charities.

Donor-advised funds also lack the institutional flexibility that private foundations can provide. Staff is shared with the other funds administered by the foundation, and community foundations generally limit the duration of the donor's right to appoint advisors for the fund. On the other hand, the staff of community foundations can often provide donors with detailed knowledge about charitable organizations and needs within their communities.

COMMERCIALLY ADMINISTERED DONOR-ADVISED FUNDS

A more recent development is the creation of large donor-advised funds by for-profit companies. Fidelity Investments, the largest mutual fund company, was the first to aggressively pursue this idea, receiving a determination letter recognizing the tax-exempt public charity status of the Fidelity Investments Charitable Gift Fund in 1991. As of November 1999, the fund had received over $2 billion in donations from 18,000 donors, had made grants of over $1 billion to 50,000 charities, and had assets of $1.7 billion.[13]

Private foundations are the most flexible means for ensuring that assets committed to charitable purposes will continue to serve those purposes.

Several other companies, including the Vanguard Group, the second largest mutual fund company, and American Guaranty & Trust Company, have since followed suit.

The structure of these funds is relatively straightforward. Donors are required to make a minimum contribution ($10,000 for the Fidelity fund). When they make their contribution they are able to choose which of several investment pools in which they want their contribution invested. After this initial

[10] Shoemaker et al, "Donor Control," *Continuing Professional Education, Exempt Organizations—Technical Instruction Program for FY 1999* (1998), page 297; Johnson and Jones, "Community Foundations," *Continuing Professional Education, Exempt Organizations—Technical Instruction Program for FY 1994* (1993), page 135.

[11] The Foundation Center, *Foundation Giving* (1999 Edition) at xi.

[12] Although the IRS has expressed concern about organizations that come too close to turning donor recommendations into donor commands, it has rarely taken action against community foundations. Shoemaker and Henchey, "Donor Directed Funds," *Continuing Professional Education, Exempt Organizations—Technical Instruction Program for FY 1996* (1995), page 328.

[13] Press release, "Fidelity Investments Charitable Gift Fund Ranks Third Largest" (11/1/99).

choice, investment of their contribution is controlled by the fund's board, which hires the for-profit company that established the fund to serve as the manager of the fund's assets. Donors may then recommend that donations be made from their account to charitable organizations.[14] The fund conducts a minimal review of the recommendations, usually to ensure simply that the recipient is, in fact, a public charity.[15] Since the fund is itself a public charity, donors are able to take a charitable deduction at the time of their contribution, even if it is years before any donations are made from their accounts with the fund. The fund's public charity status is based on it being supported by the public—i.e., by many unrelated donors.

A supporting organization is tied to specific organizations and its activities are limited to supporting those organizations.

The exemption application for the Fidelity fund apparently flew below the Service's radar screen, being approved by the Brooklyn District office without any review by the National Office. Since the fund came to the attention of the National Office, the IRS has repeatedly expressed concerns about this type of fund in general terms.[16] As a result, the Vanguard and American Guaranty funds received a much higher degree of scrutiny, although they both ultimately received recognition of their tax-exempt public charity status.

As prerequisites for its favorable rulings on these two funds, the Service (1) imposed a minimum payout requirement of 5% (clearly drawn from the private foundation minimum payout requirement), (2) required assurances that the boards of the funds would be controlled by a majority of directors independent of the for-profit companies, (3) required a commitment to investigate if the fund learned that any donor was personally benefiting from a recommended donation to a public charity (for example, by having the fund fulfill a pledge made by the donor or pay for a scholarship for a child of the donor), and (4) required appropriate safeguards in the management agreement between the fund and the for-profit company. The American Guaranty fund was also required to change its name to "American Gift Fund" from "American Guaranty Philanthropic Fund" (to reduce its identification with the for-profit company), and to change its controlling trust document to guarantee a majority of independent directors. These requirements apparently were not imposed on the Vanguard fund.[17]

Commercially administered funds provide many of the same advantages and disadvantages as donor-advised funds controlled by community foundations, but there are key differences. Although community foundations may impose geographic limitations absent from the commercial funds, they generally provide donors with a high level of expertise concerning potential donees within their service areas. Donors and their advisors should also carefully compare investment and administration fees.[18]

THE TRADE-OFFS—ADVANTAGES

As discussed in detail below, the federal tax rules governing private foundations are significantly less favorable than those for public charities in a number of important respects. Nonetheless, many well-advised donors continue to select private foundations as the vehicle through which to pursue their charitable objectives. The reason is that private foundations provide donors the broadest flexibility in creating a charitable organization that can

[14] Newspaper reports indicate that donors often believe they have absolute control over donations, a perception undoubtedly reinforced by language such as the following from a recent Fidelity fund brochure: "Once you have recommended a grant, the Gift Fund will distribute the appropriate amount from your account to the charity." Wall St. J., 2/12/98, page A1. The current Fidelity fund's "Program Circular" states, however, that "All grant recommendations are subject to approval by the Trustees."

[15] The Fidelity fund has reportedly tightened its restrictions on donors recommending donations that result in personal benefits to themselves, although it remains somewhat unclear whether the fund has an effective means of enforcing these restrictions. *Wall St. J., supra*, note 14.

[16] Shoemaker et al, *supra* note 10; Shoemaker and Henchey, *supra* note 12.

[17] "The American Gift Fund's Successful March to (c)(3) Exemption, Public Charity Status, 3 Paul Streckfus' EO Journal 37 (June 1998) (reprinting the American Gift Fund's exemption application administrative file); "Vanguard's Successful March to (c)(3) Exemption, Public Charity Status," 3 Paul Streckfus' EO Journal 33 (May 1998) (reprinting the Vanguard Charitable Endowment Program's exemption application administrative file).

[18] Off-shore foundations may be another attractive option for some donors. These entities generally provide greater privacy than either private foundations or public charities, but at the cost of the donor's ability to take a charitable deduction. Many people appear not to have been deterred by this cost, as, at least according to one report, hundreds of foundations have been created outside of the United States and major European countries by donors seeking anonymity and the other advantages of avoiding the regulations imposed on foundations by these countries. Greene et al., "For Anonymous Donors, Offshore Philanthropy Can be Appealing," IX The Chronicle of Philanthropy, 13 (2/6/97).

support, nurture, and perpetuate the donor's charitable vision. There are two key dimensions to this greater flexibility—organizational flexibility and programmatic flexibility.

Organizational flexibility. Most well-advised donors who intend to commit substantial assets to a charitable fund recognize the benefit of assembling a group of advisors whose experience and expertise complement the donor's own. Donor-advised funds provide very limited practical scope for such a board of advisors. Moreover, while supporting organizations do have boards of directors, these organizations' programmatic limitations may make board service relatively unattractive to top-caliber individuals. By contrast, large private foundations have consistently been able to attract individuals of the highest caliber to serve on their boards. This is an inestimable advantage to a donor seeking to establish a major charitable institution that will pursue the donor's charitable vision over an extended period.

With a private foundation, the donor has complete freedom both to select the initial board members and to define the process through which the board will perpetuate itself. Moreover, if the donor establishes and funds a foundation during his or her lifetime, he or she will have the opportunity to work with the other directors in defining the purposes and programs of the foundation. Through this process, an intimate understanding of the donor's vision for the foundation can be shared with the initial board, thereby maximizing the chance that the foundation will remain faithful to the donor's values and vision. At the same time, a top-quality board also provides maximum assurance that the foundation will evolve in constructive ways in response to changed circumstances arising after the donor's death.

A second key strength of private foundations that clearly distinguishes them from donor-advised funds (though not from supporting organizations) is the ability to hire professional staff to assist the board in administration. While both community foundations and commercially administered donor-advised funds have professional staff, their staff members work for the entity administering the fund rather than for the donor or the fund itself. Moreover, the amount of staff support provided to the typical donor-advised fund is relatively limited. By contrast, a private foundation is limited only by its resources in hiring expert professional staff to devote its full-time efforts exclusively to the work of the foundation. Such a staff can allow the donor and the board to pursue much more sophisticated and complex strategies for achieving charitable purposes than can be pursued through the typical donor-advised fund.

Programmatic flexibility. In addition to the organizational flexibility outlined above, private foundations offer important programmatic flexibility not available through supporting organizations or donor-advised funds.

The contrast with supporting organizations turns primarily on the fact that a private foundation need not limit its charitable activities to support of a particular set of supported organizations. Instead, a donor can give his or her private foundation as broad a set of charitable purposes as desired, and can give the board as much flexibility as desired to modify the foundation's objectives over time.

The contrast with donor-advised funds involves not the breadth of charitable purpose but rather the range of available strategies for pursuing those purposes. In general, a donor-advised fund is limited to making grants to other Section 501(c)(3) organizations. It cannot engage in direct charitable activities, make program-related investments, or make grants to non-charities. Private foundations can pursue any or all of these strategies.

> **Commercial funds do provide expertise concerning potential donees within donors' geographic areas.**

THE TRADE-OFFS—DISADVANTAGES

The price of the flexibility outlined above takes the form of a number of federal tax law restrictions that are not shared by public charities, including supporting organizations, community foundations, and commercially administered donor-advised funds.

Deductibility of donations. The percentage of income limitations on the deductibility of gifts to private foundations are more restrictive than for gifts to public charities. The annual limit on the deduction for gifts to public charities is 50% of adjusted gross income for cash donations; 30% for donations of property. By contrast, donations to private foundations are subject to a 30% limit for cash donations and 20% for donations of property.[19]

[19] Donations to certain types of private foundations, such as private operating foundations, are subject to the same limits as public charities. Sections 170(b)(1)(a)(vii), (E). For corporations, the limit on deductions is generally 10% of the corporation's taxable income for contributions to both public charities and private foundations. Section 170(b)(2).

Except as provided by Section 170(e)(5), discussed below, the deduction rules for gifts of appreciated property are also significantly more favorable for gifts to a public charity. Specifically, the long-term capital gain component of intangible property, such as stocks, can be deducted in full when donated to a public charity, but is not deductible (except in the case of publicly traded stock) when donated to a private foundation. The long-term capital gain component of tangible personal property can also be deducted in full when given to a public charity (but not when given to a private foundation), as long as the public charity uses the property in a manner related to its exempt purposes.[20]

Community foundations generally limit the duration of the donor's right to appoint advisors for the fund.

There is a significant exception to the lower limits on gifts to private foundations. Under Section 170(e)(5), the long-term capital gain component of publicly traded stock can be deducted in full when donated to a private foundation.[21] This provision is especially beneficial to a donor when the stock being donated is highly appreciated. By donating the stock, the donor both receives a substantial deduction and avoids capital gains tax.

Program limitations. Both public charities and private foundations must serve charitable, educational, or other purposes specified in Section 501(c)(3). Both types of organizations are also barred from engaging in partisan electoral activities. Private foundations, however, are completely barred from attempting to influence federal, state, or local legislation, though they may make grants to public charities that lobby if those grants are not earmarked for lobbying.[22] By contrast, public charities may engage in some lobbying, as long as the lobbying either is "insubstantial" or—if the public charity has made the election under Section 501(h) to be subject to the Section 4911 lobbying rules—results in lobbying expenditures that do not exceed specified dollar limits.

Like public charities, private foundations are allowed to make grants to individuals for travel, study, or similar purposes—for example, scholarships and fellowships. Unlike public charity grants, the grants of private foundations must meet certain conditions, the most important of which is advance IRS approval for individual grant programs.[23]

Private foundations are also allowed to make grants to organizations other than public charities—other private foundations, organizations exempt under other parts of Section 501(c), and for-profit organizations (for charitable purposes). Again unlike public charities, however, foundations must exercise "expenditure responsibility" for such grants.[24] This includes making a pre-grant inquiry, drawing up a written grant agreement with certain specified terms, periodic reports by the grantee to the foundation, and reporting information about the grant to the IRS as part of the annual Form 990-PF.

Transactions with insiders. Private foundations are subject to strict "self-dealing" rules regarding transactions with "disqualified persons," usually foundation managers, directors, substantial contributors, and their families and controlled entities.[25] Before the passage of the Section 4958 intermediate sanctions, public charities did not have any such restrictions other than a bar on "private inurement"—generally the provision of unreasonable economic benefits to an insider of the public charity. Now, however, public charities are subject to a more comprehensive set of rules. These rules differ significantly from the self-dealing rules, however, primarily because the self-dealing rules start from the position that transactions with insiders should generally not be allowed, while the intermediate sanctions rules start from the position that such transactions should be allowed as long as they are done on fair market value terms.

Investment holdings. Private foundations are subject to two major restrictions on their investment activities. First, under Section 4943, private foundations are generally not allowed to own more than 20% of the voting stock of any business enterprise. The limit increases to 35% if the foundation can establish that a third party has effective control of the business. For

[20] Section 170(e)(1)(B)(i).

[21] This provision is limited to gifts of stock which in aggregate (including gifts by the donor's family) total no more than 10% of all the outstanding stock of the corporation. Section 170(e)(5)(C).

[22] Sections 4945(d)(1), (e); Reg. 53.4945-2.

[23] Sections 4945(d)(3), (g); Reg. 53.4945-4(a)(3)(ii).

[24] Section 4945(h); Regs. 53.4945-5(b) - (f)

[25] Section 4946; Reg. 53.4946-1. "Disqualified person" is defined separately for the intermediate sanctions on excess benefit transactions (Section 4958(f)(1); Prop. Reg. 53.4958-3), though the overlap is considerable.

determining if either the 20% limit or 35% limit has been reached, the stock owned by the foundation's disqualified persons is also counted. As can readily be imagined, this limitation on business holdings is particularly problematic when a donor is interested in funding a private foundation with stock of a family business.

In addition, under Section 4944, private foundations are subject to tax if they make investments that jeopardize their charitable purpose. Investments carried on with ordinary business care and prudence will pass muster under this standard and no category of investments is treated as a per se violation. The regulations do, however, direct the IRS to closely scrutinize certain types of risky investments.[26] No analogous federal tax law limits either the size of business holdings that public charities can own or the type of investments that a public charity can hold, although public charities are subject to state law fiduciary duty requirements with respect to the management of their charitable assets. This lack of restrictions generally gives public charities greater flexibility in their investment decisions than private foundations enjoy. Many universities have substantial endowments that are invested in a wide range of bonds, stocks, and even venture capital projects.[27]

Taxes. Both public charities and private foundations are subject to UBIT on any unrelated business income they receive. Private foundations are also subject to an excise tax on their "net investment income"—generally comprised of interest, dividends, rents, royalties, and capital gains, less the deductions associated with the production of that income.[28] The basic rate of the tax is 2%, but that rate is reduced by Section 4940(e) to 1% for any year in which a foundation's payments and grants for charitable activities exceeds a base amount determined in relation to the foundation's charitable expenditures in prior years.[29]

CONCLUSION

A donor who wants to dedicate substanstial assets to charitable purposes has a range of options to consider. Each option—private foundations, supporting organizations, community foundations, and commercial funds—provides different trade-offs between organizational flexibility, programmatic flexibility, and regulatory limitations. Therefore, the donor and his or her advisors should develop a clear understanding of the charitable purpose and vision that the assets will serve, so they can choose the best charitable vehicle for achieving the donor's purpose. ■

[26] Reg. 53.4944-1(a)(2).

[27] The only exception is that organizations qualifying for public charity status under Section 509(a)(2) are limited to normally receiving not more than a third of their support from investment income. Section 509(a)(2)(B).

[28] Section 4940.

[29] Section 4940(e).